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No. 288

In the Supreme Court of the United States

OCTOBER TERM, 1930

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THOMPSON OIL & GAS COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Tenth Circuit, entered in the above cause on April 5, 1930 (R. 39), reversing the decision of the United States Board of Tax Appeals. (R. 16.)

STATEMENT

The question presented is whether in determining the value or cost of oil reserves to be used in calculating the unit value per barrel upon which

depletion is annually computed under Section 234 (a) (9) of the Revenue Act of 1918 with respect to an oil lease acquired prior to March 1, 1913, the Commissioner is required to deduct from the value of the lease on March 1, 1913, plus the cost of capital additions thereafter, (1) the actual depletion sustained since March 1, 1913, or (2) merely the depletion allowed as deductions from gross income since that date.

The respondent owned an oil and gas mining lease acquired prior to March 1, 1913. On that date the recoverable oil reserves embraced by the lease were 278,000 barrels, and the value thereof was $156,645, or $.56347 per barrel. In the last ten months of 1913, in 1914 and 1915, the respondent extracted 162,717.03 barrels of oil, and, at the unit rate mentioned, *sustained* depletion of its oil in the amount of $91,686.15. During this same period the total depletion *allowed* respondent from its gross income amounted to only $6,322.02, because the Revenue Act of 1913, then in force, restricted the annual deduction allowed for depletion to 5% of the gross production of the respondent, which for this period totaled $126,440.44. (R. 14–15; see *infra*, p. 7.)

In 1916 the respondent secured an extension of its lease at a cost of $30,000, by which its oil reserves were increased 300,000 barrels. At this time there remained of the original reserve 115,283 barrels, having a March 1, 1913 value of $64,958.85. By adding to this depleted March 1, 1913 value the

cost of the extension of the lease, and by increasing the remaining oil reserves by the additional 300,000 barrels the Commissioner found a new total recoverable reserve of 415,283 barrels, having a basic value or cost of $94,958.85, or $.22866 per barrel. (R. 15–16.)

In 1916 and 1917 the respondent produced 49,452 barrels and 39,204 barrels of oil, respectively, on which it sustained depletion in the respective amounts of $11,307.69 and $8,964.39. During 1918 the respondent produced 33,697 barrels, upon which it sustained depletion in the amount of $7,705.16, determined at the unit rate of $.22866 per barrel, which amount the Commissioner allowed as a deduction from gross income for 1918. (R. 16.) It is the depletion allowance for 1918 which is here in question.

Respondent contended that the unit rate of depletion per barrel for 1918 should have been based upon the original March 1, 1913 value of the oil reserves, plus the cost of the extension of the lease, and less only that portion of the depletion sustained in 1913, 1914 and 1915 which was *allowed* to it as deductions (i. e., $6,322.02). The Commissioner, in determining the capital value of the total reserve upon which depletion for 1918 should be based, adopted the March 1, 1913 value of the reserve, plus the cost of the extension of the lease, less the full amount of the depletion *sustained* in the years 1913, 1914 and 1915 (i. e., $91,686.15), holding that

the entire depletion sustained in those years should be deducted from the original March 1, 1913 value whether allowable as deductions or not. Note: No question is here raised as to the correctness of the amount of depletion deducted by the Commissioner for 1916 and 1917 in computing the depletion allowance for 1918.

The Board of Tax Appeals sustained the Commissioner. (R. 20.) The Circuit Court of Appeals, relying upon *United States* v. *Ludey*, 274 U. S. 295, held that in determining in 1918 the value or cost of the reserves then recoverable through depletion allowances there should be deducted from the original March 1, 1913 value or cost only so much of the depletion sustained between March 1, 1913 and December 31, 1917 as was legally allowable as deductions during that period, and, accordingly, reversed the decision of the Board. (R. 32–38.)

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred in holding that the capital value in 1918 of oil-mining properties, acquired prior to March 1, 1913, recoverable through depletion allowances, is the March 1, 1913, value of the oil reserves, plus the cost of subsequent additions and minus only the depletion of the reserves in prior years which were allowed as deductions from gross income of such years.

REASONS FOR GRANTING THE WRIT

1. The effect of the decision below is to overthrow regulations which have been in force for ten

years and which have received legislative approval through the reenactment of Section 234 (a) (9) of the Revenue Act of 1918 in later revenue acts without substantial change. Regulations 62, Article 202, construing Section 234 (a) (9) of the Revenue Act of 1921; Regulations 65, Article 202, construing Section 234 (a) (8) of the Revenue Act of 1924; Regulations 69, Article 202, construing Section 234 (a) (8) of the Revenue Act of 1926.

2. The decision below authorizes a deduction in 1918 for depletion actually sustained in earlier years. This is in conflict with the settled principle that losses are deductible only for the year in which sustained (*DeLoss* v. *Commissioner*, 28 F. (2d) 803 (C. C. A. 2d); *Burns* v. *Commissioner*, 31 F. (2d) 399 (C. C. A. 5th), certiorari denied, 280 U. S. 42A), and defeats the purpose of Section II, B of the Revenue Act of 1913 which limited depletion deductions in the case of mines to 5% of the gross value of the production.

3. The instant case presents a question of statutory construction which is of present importance in administering tax laws, since it is involved in numerous cases now pending in the courts, the Board of Tax Appeals and the Bureau of Internal Revenue.

Wherefore, it is respectfully submitted that the petition should be granted.

THOMAS D. THACHER,
Solicitor General.

JULY, 1930.

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The findings of fact and opinion of the Board of Tax Appeals (R. 14–21) are reported in 15 B. T. A. 993. The opinion of the Circuit Court of Appeals (R. 32–38) is not yet reported.

JURISDICTION

The order of the Circuit Court of Appeals reversing the decision of the Board of Tax Appeals was entered on April 5, 1930. (R. 39.) Jurisdiction is conferred upon this Court by Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether under Section 234(a)(9) of the Revenue Act of 1918 in determining for any taxable year the capital value recoverable through depletion allowances of oil-mining properties acquired prior to March 1, 1913, there should be deducted from the March 1, 1913 value the amount of depletion actually *sustained* in earlier years or only so much of such depletion as was *allowable* as deductions in those years.

The Revenue Act of 1913, c. 16, 38 Stat. 114, 167 provides in part:

SECTION II. B.

* * * * *

That in computing net income * * * there shall be allowed as deductions: * * * sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, * * *.

The Revenue Act of 1916, c. 463, 39 Stat. 756, 767–768, provides in part:

SEC. 12. (a) In the case of a corporation * * * such net income shall be ascertained by deducting from the gross amount of its income * * *

* * * * *

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including * * * (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; * * *.

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, 1078, provides in part:

SEC. 234. (a) That in computing the net income of a corporation subject to the tax

imposed by section 230 there shall be allowed as deductions:

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of costs up to that date: * * * such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

Regulations 45, promulgated January 28, 1921, under the Revenue Act of 1918, provides:

ART. 203. *Capital recoverable through depletion deductions in the case of lessee.*— (a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year. The capital recoverable

through depletion is the total capital remaining less the sum recoverable through depreciation.

STATEMENT

The facts are sufficiently stated in the petition.

ARGUMENT

On March 1, 1913, respondent's oil reserve contained 278,000 barrels of oil, valued at $156,645. During ten months of 1913, and during 1914 and 1915, 162,717 barrels of oil valued, on a March 1, 1913 basis, at $91,686.15, were removed. During this same period the annual deductions allowed respondent from its gross income on account of depletion totaled $6,322.02—said amount being 5% of respondent's gross production during this period, which was the maximum amount of depletion permitted as a deduction under the Revenue Act of 1913. The regulations under which respondent's 1918 allowance was computed (see p. 8, *supra*) provided that the prior depletion "sustained, whether legally allowable or not" should be deducted from the March 1, 1913 value to determine the basis for the annual allowance. Accordingly, in computing the tax for 1918, the Commissioner based the depletion allowance upon the original March 1, 1913 value of the recoverable oil less the depletion actually sustained in 1913, 1914 and 1915 (i. e. $91,686.15), although during these years the depletion allowable as deductions under the 1913 Act amounted only to $6,322.02. It is not contended

that any of the values used by the Commissioner were erroneous and it is not denied that the oil reserve has been actually depleted in the amount by which it was reduced by the Commissioner in computing the 1918 allowance. Respondent's contention is that the original March 1, 1913 value should not have been reduced by the actual amount of depletion sustained prior to 1918, but only by the amount which Congress in prior years permitted to be deducted from gross income. In determining the annual depletion allowances for 1918 and subsequent years, the respondent would thus increase the value of the remaining oil as fixed by the Commissioner by more than $85,000, although it is conceded that the remaining oil has been correctly valued by the Commissioner.

The question is one of statutory construction. Section 234 (a) (9) provides for "a reasonable allowance" for depletion to be made "under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary." The regulations in question were made pursuant to this statutory authority and the depletion allowance made in this case was strictly in accord with the regulations. But it is contended that the 1918 allowance was not a reasonable one because it was not based upon the theory that there must ultimately be returned to the taxpayer in depletion allowances his entire original capital investment free from tax.

In the years 1913 to 1915, inclusive, when $91,686.15 of depletion was actually sustained, the Revenue Act of 1913 limited the annual depletion deduction to "not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made." (See p. 7, *supra*.) The validity of this arbitrary limit was sustained in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103. Since the decision of the court below authorizes an allowance in 1918 for depletion *actually sustained in earlier years*, the necessary effect of that decision is to give to the taxpayer in 1918 a deduction which the statute expressly prohibited him from taking in earlier years. There is nothing in the 1918 Act which provides that all depletion sustained in any prior year which was not allowable as a deduction from gross income in such year should, in effect, be allowed as part of the depletion deductions in later years, so that when the asset is finally exhausted its full value must have been allowed as deductions from gross income. The 1918 Act merely provides for "a reasonable allowance" and it is submitted that this can not be interpreted to mean more than a reasonable allowance based upon the exhaustion which actually occurs during the year for which the tax is determined.

It is now well settled that an owner of oil and mining properties is not entitled *as a matter of right* to make any deduction from gross income on

account of the extraction and sale of the mineral which produces the income. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503; *Goldfield Consol. Mines Co.* v. *Scott*, 247 U. S. 126; *United States* v. *Biwabik Mining Co.*, 247 U. S. 116; *New Creek Co.* v. *Lederer*, 295 Fed. 433, 435, certiorari denied, 265 U. S. 581. The taxpayer is entitled only to what the statute gives. *Kentucky Tobacco Products Co.* v. *Lucas*, 5 F. (2d) 723, 728. In the Corporation Tax Law of 1909, c. 6, 36 Stat. 11, 112, Congress failed to make provision for any deduction on account of depletion of mineral reserves. In later Acts provision was made for depletion deductions, but in none of the Acts since 1913 has Congress evidenced any intention of offsetting the limited allowance provided by the 1913 Act by a commensurate increase in the basic value of the remaining reserve. The effect of the decision below is to increase fictitiously the value of the respondent's remaining reserve by the $85,000 difference between the depletion sustained and that allowed under the 1913 Act. By that decision a value is attributed to the remaining reserve in excess of its conceded value, and a deduction is permitted in 1918 which was not sustained in that year. This is contrary to the accepted principle that losses are deductible only for the year in which sustained. *DeLoss* v. *Commissioner* (C. C. A. 2d), 28 F. (2d) 803; *Burns* v. *Commissioner* (C. C. A. 5th), 31 F. (2d) 399, certiorari denied, 280 U. S. 42A.

The court below recognized that its decision resulted in attributing an excessive value to the remaining reserve, but thought that result was required by the decision in *United States* v. *Ludey, supra.* That case involved the question of gain or loss upon a *sale* of oil properties. As long ago as *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, it was settled that in order to determine whether there has been gain or loss upon the sale of capital assets there must be withdrawn from the gross proceeds an amount sufficient to restore the capital value that existed at the beginning. Only the amount remaining is income. Accordingly it was necessary in the *Ludey case* to compute the depleted cost by deducting from the original cost only the actual amount of depletion which had been allowed theretofore. In determining gain or loss from a sale the taxpayer must get back his cost, and depletion enters into the calculation for the purpose of determining how much of his cost has already been returned to him. For this purpose the sustained depletion is not important. Therefore, this Court, in the *Ludey case,* decided that the original cost must be reduced only to the extent that it had already been recovered in the form of allowed depletion. But it does not follow that the same rule applies in this case, where no question of gain or loss is involved and where the only question is what allowance Congress intended the taxpayer to have as a deduction from gross income.

Section 234 (a) (9) of the 1918 Act does not provide a deduction of the precise amount of the actual depletion. Nor does the section attempt to provide how the annual allowance shall be determined. This depends upon many variable factors which are impossible of exact ascertainment. Accordingly, Congress merely provided for a "reasonable allowance," to be made under rules and regulations prescribed by the Treasury Department. Under this specific statutory authority the Treasury Department promulgated the regulations which have been referred to above. These regulations have been in force for ten years and have received legislative approval through re-enactment of the pertinent provision of the 1918 Act in subsequent revenue acts without substantial change. (See Regulations 62, Article 202, construing Section 234 (a) (9) of the Revenue Act of 1921; Regulations 65, Article 202, construing Section 234 (a) (8) of the Revenue Act of 1924; Regulations 69, Article 202, construing Section 234 (a) (8) of the Revenue Act of 1926.) We submit that they provide a reasonable allowance for depletion and that under the settled rule the regulations should not be disturbed. *Brewster* v. *Gage*, 280 U. S. 327.

CONCLUSION

The decision below overturns regulations of many years standing and has introduced confusion and uncertainty in the administration of the tax laws. Many cases, involving in the aggregate large

sums of money, are affected by the decision. In view of this and the need for a definite rule for the guidance of the courts and the Treasury Department it is respectfully submitted that the petition should be granted.

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